

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re :
LEHMAN BROTHERS HOLDINGS INC., : Chapter 11 Case No.
et al., : 08-13555 (JMP)
Debtors. : (Jointly Administered)
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REPORT OF
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Sections I & II: Introduction, Executive Summary & Procedural Background

Section III.A.1: Risk

maintain its ratings and confidence. So at the end of the second quarter of 2008, as Lehman was forced to announce a quarterly loss of \$2.8 billion – resulting from a combination of write-downs on assets, sales of assets at losses, decreasing revenues, and losses on hedges – it sought to cushion the bad news by trumpeting that it had significantly reduced its net leverage ratio to less than 12.5, that it had reduced the net assets on its balance sheet by \$60 billion, and that it had a strong and robust liquidity pool.¹⁹

Lehman did not disclose, however, that it had been using an accounting device (known within Lehman as “Repo 105”) to manage its balance sheet – by temporarily removing approximately \$50 billion of assets from the balance sheet at the end of the first and second quarters of 2008.²⁰ In an ordinary repo, Lehman raised cash by selling assets with a simultaneous obligation to repurchase them the next day or several days later; such transactions were accounted for as financings, and the assets remained on Lehman’s balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but because the assets were 105% or more of the cash received, accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets

¹⁹ Final Transcript of Lehman Brothers Holdings Inc. Second Quarter Preliminary Earnings Call (June 9, 2008), at pp. 7-8.

²⁰ LBHI 2007 10-K, at p. 63; LBHI 10-Q Apr. 9, 2008, at p. 72; Lehman Brothers Holdings Inc., Quarterly Report as of May 31, 2008 (Form 10-Q) (filed on July 10, 2008), at p. 88 (“LBHI 10-Q July 10, 2008”); Examiner’s Interview of Martin Kelly, Oct. 1, 2009; Examiner’s Interview of Ed Grieb, Oct. 2, 2009.

could be removed from the balance sheet.²¹ With Repo 105 transactions, Lehman's reported net leverage was 12.1 at the end of the second quarter of 2008; but if Lehman had used ordinary repos, net leverage would have to have been reported at 13.9.²²

Contemporaneous Lehman e-mails describe the "function called repo 105 whereby you can repo a position for a week and it is regarded as a true sale to get rid of net balance sheet."²³ Lehman used Repo 105 for no articulated business purpose except "to reduce balance sheet at the quarter-end."²⁴ Rather than sell assets at a loss, "[a] Repo 105 increase would help avoid this without negatively impacting our leverage ratios."²⁵ Lehman's Global Financial Controller confirmed that "the only purpose or motive for [Repo 105] transactions was reduction in the balance sheet" and that "there was *no substance* to the transactions."²⁶

Lehman did not disclose its use – or the significant magnitude of its use – of Repo 105 to the Government, to the rating agencies, to its investors, or to its own Board

²¹ See Section III.A.4 (discussing Repo 105).

²² LBHI 10-Q July 10, 2008, at p. 89; Duff & Phelps, Repo 105 Balance Sheet Accounting Entry and Leverage Ratios Summary (Oct. 2, 2009), at p. 7. See also Section I.A of this Report, which discusses net leverage.

²³ E-mail from Anthony Jawad, Lehman, to Andrea Leonardelli, Lehman (Feb. 29, 2008) [LBEX-DOCID 224902].

²⁴ E-mail from Raymond Chan, Lehman, to Paul Mitrokostas, Lehman, *et al.* (Jul. 15, 2008) [LBEX-DOCID 3384937].

²⁵ Joseph Gentile, Lehman, Proposed Repo 105/108 Target Increase for 2007 (Feb. 10, 2007), at p. 1 [LBEX-DOCID 2489498], attached to e-mail from Joseph Gentile, Lehman, to Ed Grieb, Lehman (Feb. 10, 2007) [LBEX-DOCID 2600714].

²⁶ Examiner's Interview of Martin Kelly, Oct. 1, 2009, at p. 9.

of Directors.²⁷ Lehman's auditors, Ernst & Young, were aware of but did not question Lehman's use and nondisclosure of the Repo 105 accounting transactions.²⁸

In mid-March 2008, after the Bear Stearns near collapse, teams of Government monitors from the Securities and Exchange Commission ("SEC") and the Federal Reserve Bank of New York ("FRBNY") were dispatched to and took up residence at Lehman,²⁹ to monitor Lehman's financial condition with particular focus on liquidity.³⁰

²⁷ Lehman did not disclose its use of Repo 105 in public filings. Examiner's Interview of Ed Grieb, Oct. 2, 2009, at p. 14; Examiner's Interview of Marie Stewart, Sept. 2, 2009, at p. 15; Examiner's Interview of Matthew Lee, July 1, 2009, at p. 16. Lehman did not disclose its use of Repo 105 to rating agencies. See Lehman, S&P Ratings Q2 2008 Update (June 5, 2008) [S&P-Examiner 000946] (Lehman did not disclose its use of Repo 105 to Standard & Poor's in its ratings presentation); Lehman, Fitch Ratings Q2 2008 Update (June 3, 2008) [LBHI_SEC07940_513239] (Lehman similarly did not disclose its use of Repo 105 to Fitch as part of its presentation where Lehman touted its balance sheet reduction). The Examiner interviewed representatives from the three leading ratings agencies, Fitch, S&P and Moody's, and none had knowledge of Lehman's use of Repo 105/108 transactions, either by name or by description. Examiner's Interview of Eileen A. Fahey, Sept. 17, 2009, at p. 7; Examiner's Interview of Diane Hinton, Sept. 22, 2009, at p. 6; Examiner's Interview of Peter E. Nerby, Oct. 8, 2009, at p. 5. Lehman did not disclose its use of Repo 105 to Government regulators. Examiner's Interview of Ronald S. Marcus, Nov. 4, 2009, at p. 11; Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 5; Examiner's Interview of Jan H. Voigts, Oct. 1, 2009. Lehman did not disclose its use of Repo 105 to its Board of Directors. Examiner's Interview of Dr. Henry Kaufman, Sept. 2, 2009, at p. 21; Examiner's Interview of Jerry A. Grundhofer, Sept. 16, 2009, at p. 10; Examiner's Interview of Roland Hernandez, Oct. 2, 2009; Examiner's Interview of Sir Christopher Gent, Oct. 21, 2009, at p. 22; Examiner's Interview of Roger Berlind, Dec. 18, 2009, at p. 4.

²⁸ Examiner's Interview of Ernst & Young, Repo 105 session, Oct. 16, 2009, at pp. 8-9 (statement of William Schlich); Examiner's Interview of Ernst & Young, Nov. 3, 2009, at pp. 14-15 (statement of Hillary Hansen).

²⁹ Examiner's Interview of Matthew Eichner, Nov. 23, 2009, at p. 5 (Eichner told the Examiner that after Bear Stearns nearly collapsed, the SEC had monitors on-site at Lehman "almost all the time." Eichner also told the Examiner that the FRBNY had people "in residence" with actual offices at Lehman); Examiner's Interview of Jan H. Voigts, Aug. 25, 2009, at p. 1 (Voigts monitored Lehman's liquidity position, embedded on-site with the firm, from March 16, 2008 through mid-September, 2008).

³⁰ Examiner's Interview of Timothy F. Geithner, Nov. 24, 2009, at p. 4 (after Bear Stearns nearly collapsed, Geithner met with Lehman and other investment banks about moving the banks to a "more conservative place" regarding capital and liquidity. Geithner indicated that his primary concern was Lehman's funding structure. He told the Examiner that he was "consumed" with figuring out how to make Lehman "get more conservatively funded").

Lehman publicly asserted throughout 2008 that it had a liquidity pool sufficient to weather any foreseeable economic downturn.³¹

But Lehman did not publicly disclose that by June 2008 significant components of its reported liquidity pool had become difficult to monetize.³² As late as September 10, 2008, Lehman publicly announced that its liquidity pool was approximately \$40 billion;³³ but a substantial portion of that total was in fact encumbered or otherwise illiquid.³⁴ From June on, Lehman continued to include in its reported liquidity substantial amounts of cash and securities it had placed as “comfort” deposits with various clearing banks; Lehman had a technical right to recall those deposits, but its ability to continue its usual clearing business with those banks had it done so was far from clear.³⁵ By August, substantial amounts of “comfort” deposits had become actual

³¹ Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Preliminary Earnings Call (June, 9, 2008), at p. 8 (Lehman’s liquidity pool reported at \$45 billion); Final Transcript of Lehman Brothers Holdings Inc. Second Quarter 2008 Earnings Call (June 16, 2008), at p. 6 (Lehman’s liquidity pool reported at \$45 billion); Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 10 (Lehman’s liquidity pool reported at \$42 billion).

³² Lehman, Liquidity Pool Table Listing Collateral and Ability to Monetize (Sept. 12, 2008) [LBEX-WGM 784607] (listing \$30.1 billion of assets as “low ability to monetize”).

³³ Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008), at p. 10.

³⁴ Examiner’s Interview of Paolo R. Tonucci, Sept. 16, 2009, at p. 19 (Lehman included \$2 billion that it pledged to Citibank as a comfort deposit in its liquidity pool); Security Agreement between LBHI and Bank of America, N.A. (Aug. 25, 2008) [LBEX-DOCID 000584] (providing for a \$500 million security deposit from Lehman to BofA); Lehman, Liquidity Pool Table Listing Collateral and Ability to Monetize (Sept. 9, 2008), at p. 2 [LBHI_SEC07940_557815] (showing the \$500 million BofA deposit in the liquidity pool); Lehman, Liquidity Update (Sept. 10, 2008), at p. 3 (\$1 billion in Lehman’s liquidity pool was earmarked to HSBC and listed as “Low ability to monetize.”).

³⁵ See Section III.A.5 (discussing potential claims against secured lenders).